DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS

NUMBER: 97-0175

GROSS AND ADJUSTED GROSS INCOME TAXES FOR THE PERIOD 1993–95

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ISSUES

I. Gross Income Tax—Imposition of Tax on Nonresident or Nondomiciliary Taxpayer—Receipt of Gross Income by Agent—Co-Op Advertising

Authority: IC §§ 6-2.1-1-2, -1-10, -1-11, -2-2(a)(2) (1993); 45 IAC § 1-1-54 (1992); *Oil Supply Co. v. Hires Parts Service, Inc.,* 726 N.E.2d 246 (Ind. 2000); *Derloshon v. City of Ft. Wayne Dep't of Redev.*, 234 N.E.2d 269 (Ind. 1968), *reh'g denied*; *Western Adj. and Insp. Co. v. Gross Income Tax Div.*, 142 N.E.2d 630 (Ind. 1957); *Dep't of Treasury v. Ice Service, Inc.*, 41 N.E.2d 201 (Ind.1942); *United Artists Theatre Circ., Inc. v. Indiana Dep't of State Revenue,* 459 N.E.2d 754 (Ind. Ct. App.), *reh'g and trans. denied* (1984); *Universal Group Ltd. v. Indiana Dep't of State Revenue,* 642 N.E.2d 553 (Ind. Tax 1994)

The taxpayer, a motion picture theater chain, argues that the field auditor erred in assessing gross income tax on reimbursements that it received for joint newspaper advertising in Indiana by it and its film distributors.

II. Adjusted Gross Income Tax—Imposition of Tax on Business Income Derived from Sources within Indiana—Apportionment of Business Income—Sales Factor

Authority: IC §§ 6-3-1-20, -1-24, -2-1(b), -2-2 (1993); 45 IAC §§ 3.1-1-29, -1-34, -1-39, -1-50 to -1-52 (1992); Information Bulletin # 12 (1993)

The taxpayer also contends that the auditor erred in assessing adjusted gross income tax to the extent that the auditor included the reimbursements for advertising in Indiana in the sales factor when the auditor apportioned the taxpayer's business income.

STATEMENT OF FACTS

The taxpayer is a corporation organized and having its principal place of business in a state adjoining Indiana. During the audit period it operated a chain of motion picture theaters in Indiana and two adjoining states, including its state of incorporation. Five of these theaters were in Indiana. The taxpayer, in the regular course of its operations during the audit period, paid for and ran advertisements in newspapers that served the markets in which each of its theaters was located, both in Indiana and in the two adjoining states. The taxpayer's representative indicated in its hearing brief that the taxpayer paid for and placed all newspaper advertisements in its sole name.

In its initial protest letter the taxpayer represented that it ran two kinds of newspaper advertisements. One type, called "directory ads," simply identified the theater in question, the titles of the motion picture/s that theater was then showing, and the show times for each motion picture. The other type, called "display ads," was specific to a given motion picture. The taxpayer submitted no examples of the latter type of advertisement to the Department; however, according to the initial protest letter, a typical display ad consisted of a photograph (for example, of a star of the film). The Audit Summary states that the taxpayer's December financial statements for each year of the audit period indicated that it received financial assistance from various film studios to help pay for the newspaper advertising costs the taxpayer incurred. The initial protest letter states that the taxpayer did not seek or receive any reimbursement from the studios for its directory ads, thereby implying that the assistance the taxpayer received was only for display ads.

However, the taxpayer has not submitted copies of any written contracts between it and the various studios with which it dealt during the audit period that governed, or included terms governing, display ads at any stage of the proceedings before the Department. At the protest hearing, the taxpayer's representative stated that there were no such contracts. Nor has the taxpayer submitted any documentary or other evidence from any of these studios indicating what the rights and duties of each party were concerning display ads. There is thus no evidence before the Department indicating which party had control over the content of the display ads. Nor is there anything in the record before the Department, other than the taxpayer's representative's assertion at the protest hearing, that the various newspapers with which the taxpayer dealt knew they were running the display ads at least in part on behalf of the respective studios.

The taxpayer's initial protest letter asserted that the bulk of the assistance was in the form of reimbursements through reductions of the license or rental fees the taxpayer paid under its various exhibition contracts with the studios. The protest letter stated that only about twenty percent (20%) of the assistance was in cash. The taxpayer set out three formulas by which the studios computed the fee reductions. However, as previously noted, the taxpayer has not submitted copies of any contracts or any other documents concerning

display ads, including any terms under which the studios may have assisted the taxpayer during the audit period. There is thus no evidence before the Department that would substantiate the taxpayer's assertions on this subject. The taxpayer did submit two invoices for advertising assistance, one for a deduction from the rental charge for the film in question and another for payment. However, both are dated 1997, after the taxpayer's audit period closed. There is thus no evidence in the record before the Department of the exact form or forms that the assistance took during the audited years.

In contrast to the taxpayer's assertions that the studios reduced the fees, the Audit Summary implies that all of the assistance was monetary. Instead of crediting the assistance to an income account, the taxpayer entered the respective amounts in an operating expense account, entitled "Co-Op Advertising" on the copy of its Income Statement for fiscal 1995 submitted with its protest. The Audit Summary states that the taxpayer would debit cash from this account to pay the advertising expenses that it incurred.

The field auditor assessed the taxpayer gross income tax on the aggregate amount of the advertising assistance. The auditor also used the amounts of the assistance in both the numerator and the denominator of the taxpayer's sales factor in computing its adjusted gross income derived from sources within Indiana, and its adjusted gross income tax liability on such income. The taxpayer protests all of these adjustments.

I. Gross Income Tax—Imposition of Tax on Nonresident or Nondomiciliary Taxpayer—Receipt of Gross Income by Agent—Co-Op Advertising

DISCUSSION

The taxpayer argues that it is not liable for the gross income tax part of the assessment for two reasons. First, it alleges that the film studios provided the advertising assistance in the form of reimbursements for the taxpayer's advances. Second, the taxpayer asserts that it acted as the agent of each of the various studios in placing and paying for the advertisements.

During the audit period the Department had codified its gross income tax regulation on agency receipts at former 45 IAC § 1-1-54 (1992) (current version at 45 IAC §§ 1.1-1-2 and –6-10 (Cum. Supp. 2000), which read in relevant part as follows:

> Sec. 54. Agents. Taxpayers are not subject to gross income tax on income they receive in an agency capacity. However, before a taxpayer may deduct such income in computing his taxable gross receipts, he must meet two (2) requirements:
>
> *(1) The taxpayer must be a true agent. Agency is a relationship which results from the manifestation of consent by one person to another authorizing the other to act on his behalf and subject to his complete control, and consent by the other to so act.* Agency may be estab-

> lished by oral or written contract, or may be implied from the conduct of the parties. *However, the representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish agency.* Both parties must intend to act in such a relationship.
>
> Characteristic of agency is the principal's right to complete and continuous control over the acts of the agent throughout the entire performance of the contract. This right to control cannot be limited to the accomplishment of a desired result. *In addition, the principal must be liable for the authorized acts of the agent.*
>
> *(2) The agent must have no right, title or interest in the money or property received or transferred as an agent.* In other words, the income received for work done or services performed on behalf of a principal must pass intact to the principal or a third party; the agent is merely a conduit through which the funds pass. *A contractual relationship whereby one person incurs expense under an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control, discussed above. ….*
>
> In summary, when applying the above factors to a taxpayer, *the critical factor is that of control. Notwithstanding the fact that the taxpayer acting for another has no right, title or interest in the money or property received, he is not entitled to deduct such income from his gross receipts unless he was acting as a true agent subject at all times to the control of his principal.*

Id (emphases added).

The taxpayer's agency argument by its own terms is governed by subsection (1), while its reimbursement argument is governed by subsection (2), of the former regulation. The taxpayer has the burden of proving each of its assertions. IC § 6-8.1-5-1(b) states that "[t]he notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Id.* The statute essentially requires the taxpayer to raise, prove and convince the Department of any affirmative defenses to the assessment that the taxpayer may have. A taxpayer's agency and absence of any right, title or interest in the assessed receipts are such defenses. *See Western Adj. and Insp. Co. v. Gross Income Tax Div.*, 142 N.E.2d 630, 635 (Ind. 1957) (stating that the taxpayer "ha[s] the burden of making out an affirmative [agency or trusteeship] case") ("*Western Adjustment*"). *Cf. Vawter v. Baker,* 23 Ind. 63, 65 (1864) (holding agency to be an affirmative defense in a breach of contract action and placing the burden of proof of agency on the defendant) ("*Vawter*"). However, the last two passages empha-

sized in the above-quoted regulation make it clear that an agency relationship must be found to exist before the question of a taxpayer's absence of any right, title or interest in receipts becomes material. Accordingly, before the Department can address the taxpayer's reimbursement argument the Department must first find that there were agency relationships between the taxpayer and each of the respective studios for which it alleges it placed the display newspaper advertisements. The Department therefore turns to this latter question first.

The definition of "agency" in subsection (1) of the former regulation is in substantial accord with Indiana judicial definitions of "agent." "An agent is one who acts on behalf of some person, with that person's consent and subject to that person's control. *See Dept. of Treasury v. Ice Service, Inc.*, 220 Ind. 64, [67-68,] 41 N.E.2d 201[, 203] (Ind.1942) ["*Ice Service*"](citing Restatement (Second) of Agency § 1(1) (1958) [sic])." *Oil Supply Co. v. Hires Parts Service, Inc.*, 726 N.E.2d 246, 248 (Ind. 2000) ("*Oil Supply*"). Therefore, "the elements of an actual agency relationship are three: [1] manifestation of consent by the principal; [2] acquiescence by the agent; and [3] control exerted by the principal." *Hope Lutheran Church v. Chellew*, 460 N.E.2d 1244, 1247 (Ind. Ct. App.) ("*Chellew*"), *reh'g and trans. denied* (1984). The principal's right to and exercise of control need not be complete. *Universal Group Ltd. v. Indiana Dep't of State Revenue,* 642 N.E.2d 553, 557-58 (Ind. Tax 1994), *granting reh'g on and withdrawing* 634 N.E.2d 891 (Ind. Tax 1994). However, as former 45 IAC § 1-1-54(1) stated, "[t]his right to control cannot be limited to the accomplishment of a desired result[,]" *id.*, which is the criterion for identifying an independent contractor. *"An agent, on the other hand, is subject to the control of the principal with respect to the details of the work."* *Western Adjustment,* 142 N.E.2d at 634 (emphasis added).

The only material that the taxpayer has offered to the Department is its uncorroborated assertion that it was acting as the studios' agent. Such statements are not proof of agency under Indiana common law. "It is a well established rule that agency cannot be proven by the declarations of the agent alone." *United Artists Theatre Circ., Inc. v. Indiana Dep't of State Revenue,* 459 N.E.2d 754, 758 (Ind. Ct. App.), *reh'g and trans. denied* (1984). Former 45 IAC § 1-1-54(1) adopted this rule in substance. "[T]he representation of one party that he is an agent of another without a manifestation of consent by the alleged principal is insufficient to establish agency." *Id.* The Department cannot presume the existence of agency relationships with the studios based solely on the taxpayer's unsubstantiated assertions in this protest. The Department cannot draw from that argument the inference taxpayer desires. "An administrative tribunal cannot rely on its own information for support of its findings, and an order of the tribunal must be based on *evidence produced in the hearing*…." *Derloshon v. City of Ft. Wayne Dep't of Redev.*, 234 N.E.2d 269, 273 (Ind. 1968) (internal quotation marks omitted; emphasis added), *reh'g denied*. The taxpayer has admitted that it paid for and placed all of the alleged advertisements in its sole name. Given the lack of any evidence of agency, the Department therefore must presume that the taxpayer contracted as a principal with the various newspapers for the display advertisements. Taxpayer, therefore, is liable as the principal for gross income tax on its receipts for those advertisements.

Former 45 IAC § 1-1-54(2) states in part that "an agreement to be reimbursed by another is not an agency relationship unless the other elements of agency exist, particularly the element of control[.]" *Id.* Since the taxpayer has not provided any evidence of agency to the Department, it is unnecessary for the Department to address the taxpayer's reimbursement argument. However, the Department would note that even if the taxpayer had submitted evidence of agency, its reimbursement evidence is insufficient. The taxpayer issued the invoices it submitted in evidence in 1997, after the audit period had ended. They are therefore irrelevant to prove what the taxpayer's advertising arrangements were with the studios whose films it showed during 1993-95.

Taxpayer, therefore, has failed to sustain its burden of proof that the part of the gross income tax assessment on the co-operative advertising payments was wrong. Those payments were part of the taxpayer's gross receipts or gross income under IC §§ 6-2.1-1-2, -1-10 and -1-11 (1993), former 45 IAC §§ 1-1-8 to -10 (1992) (repealed 1999), and former 45 IAC 1-1-17 (1992)(current version at 45 IAC § 1.1-1-10 (Cum. Supp. 2000). The field auditor was therefore correct to assess the taxpayer, a non-domiciliary corporation, for those receipts because under IC § 6-2.1-2-2(a)(2) (1993) they were taxable gross income derived from activities, businesses or sources within Indiana.

FINDING

The taxpayer's protest is denied as to this issue.

II. Adjusted Gross Income Tax—Imposition of Tax on Business Income Derived from Sources within Indiana—Apportionment of Business Income—Sales Factor

DISCUSSION

IC § 6-3-2-1(b) (1993) imposes the adjusted gross income tax on "that part of the adjusted gross income derived from sources within Indiana of every corporation." *Id.* IC § 6-3-2-2(a)(2) (1993) defines the phrase "adjusted gross income derived from sources within Indiana" in part as including "income from doing business in this state[.]" *Id.* Title 45 IAC § 3.1-1-38(4) and (5) (1992) define the term "doing business" as including "[r]endering services to customers in the state" and "[o]wnership, rental or operation of a business or of property (real or personal) in the state[,]" respectively. The present taxpayer engaged in both of these latter activities in its Indiana operations during the audit period.

As part of its Indiana operation, the taxpayer regularly had the newspapers serving its Indiana theaters' markets run advertisements for the motion pictures that the taxpayer showed in those theaters. It also regularly received co-operative advertising income from the film studios for doing so. IC § 6-3-1-20 (1993) and 45 IAC § 3.1-1-29 (1992) define "business income" in relevant part as "income arising from transactions and activity *in the regular course of the taxpayer's trade or business*…." *Id* (emphasis added). The co-

operative advertising income was therefore "business income" as defined in IC § 6-3-1-20 (1993) and 45 IAC § 3.1-1-29 (1992). Information Bulletin # 12 (1993) states that "[i]f a corporation has business income from both within and without Indiana, the corporation must apportion its income by means of the three-factor formula under IC 6-3-2-2. Indiana has generally followed the provisions of the Uniform Division of Income for Tax Purposes Act." *Id.* at 6. The field auditor therefore correctly determined that the co-operative advertising income was subject to apportionment.

IC § 6-3-2-2(b) (1993) and 45 IAC § 3.1-1-39 (1992) set out the formula. The business income from sources both within and without Indiana is multiplied by a fraction, the numerator of which is the sum of the property, payroll and sales factors. *Id.* IC § 6-3-2-2(c) to -2(e) (1993), respectively, indicate that each of these factors is itself a fraction. *See id* (so stating). The sales factor in particular "is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e) (1993). *Accord*, 45 IAC §§ 3.1-1-51 and -1-52 (1992) (respectively describing what the denominator and numerator of the sales factor include). It is the auditor's inclusion of the co-operative advertising benefits in both the numerator and the denominator of the sales factor that is in issue in this protest.

IC § 6-3-1-24 (1993) and 45 IAC §§ 3.1-1-34 and -1-50 (1992) define "sales" broadly as being "*all gross receipts* of the taxpayer not allocated under IC 6-3-3-2(g) through IC 6-3-2-2(k), other than compensation." *Id* (emphasis added). Since the Department has previously found that the co-operative advertising benefits were gross receipts, the auditor was correct to include those receipts in the denominator of the sales factor.

The auditor was also correct to include the co-operative advertising benefits in the sales factor numerator. IC § 6-3-2-2(f) (1993) sets out the criteria for determining whether such sales occur in Indiana. It states in relevant part that "[s]ales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if: (1) the income-producing activity is performed in this state[.]" *Id.* The activity of the taxpayer in issue during the audit period was its placing of display advertisements in newspapers having their principal places of business in Indiana and circulating in the markets of the taxpayer's Indiana theaters. Including the income received from those activities in the numerator of the sales factor was therefore correct.

FINDING

The taxpayer's protest is denied as to this issue.

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